

CALIFORNIA STATE TEACHERS' RETIREMENT BOARD

INVESTMENT COMMITTEE

SUBJECT: Fixed Income -
Fixed Income Policy

ITEM NUMBER: 8

ATTACHMENT(S): 2

ACTION: X

DATE OF MEETING: April 7, 1999

INFORMATION: _____

PRESENTER(S): Ms. Cunningham

EXECUTIVE SUMMARY

One of the 1998/99 objectives approved for the Investment Branch is to review each of the policies to ensure completeness and consistency, with revisions to be made as necessary.

Attachment 1 represents the Long-Term Fixed Income Policy Manual, which outlines the policies of CalSTRS' internally managed long-term core Fixed Income portfolios. This manual includes revisions to the previous Fixed Income Policy Manual that was updated in May 1996. Most of the revisions represent changes in format and structure, in order to be consistent with the other portfolios and programs managed within the Investment Branch. The most significant revision is to the daily authorization limits for the Investment Officers within Fixed Income, identified under Policy 6. These changes to the authorization levels were primarily as a result of the increased size of the portfolios. Policy 2 was also revised to reflect that the Investment Committee shall be responsible for selecting the performance benchmark for Fixed Income. Previously, the Director of Fixed Income had that responsibility.

These policies have been designed to set the boundaries that will ensure prudence and care in the management of the Fixed Income portfolios, while allowing sufficient flexibility in the management process to capture investment opportunities. Also included is a flow chart in order to provide the context for the policies within the general process of the management of the Fixed Income portfolios. The policies are intended to be static in nature and will be returned to the Investment Committee prior to changes being implemented.

RECOMMENDATION

Staff and Pension Consulting Alliance recommend that the Investment Committee approve the Long-Term Fixed Income Policy Manual by adopting the attached resolution (Attachment 2).

CalSTRS

CALIFORNIA STATE TEACHERS' RETIREMENT SYSTEM

LONG-TERM FIXED INCOME POLICY MANUAL

INVESTMENT BRANCH
April, 1999

California State Teachers' Retirement System
Long-Term Fixed Income Policy Manual

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INTRODUCTION

Fixed income portfolios can be considered unique in that they represent an investment asset class that bridges the return and risk characteristics between cash equivalents and stocks. The California State Teachers' Retirement System's (CalSTRS; System) core long-term fixed income holdings play several important roles within the investment portfolio. These roles include providing diversification, a real rate of return, and cash flow/liquidity.

The Long-Term Fixed Income Portfolios ~~consisting of investments in~~ invest in a wide range of dollar denominated securities, including, but not limited to:

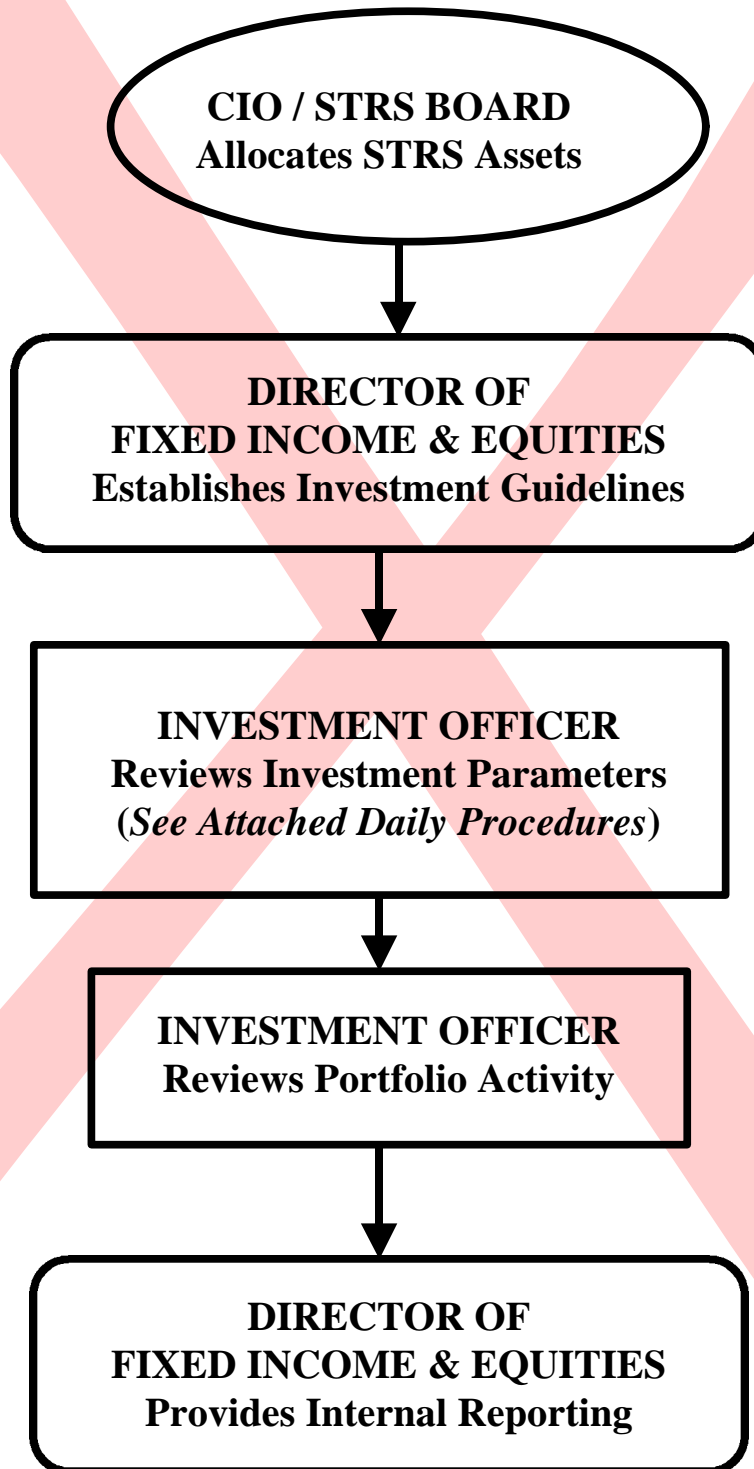
- ~~Liquidity Securities~~
- ~~Private Placements~~
- U.S. Treasury ~~Securities~~ Bonds/Notes
- U.S. Agency ~~Securities~~ Bonds/Notes
- U.S. Government-Sponsored Corporations
- U.S. Corporate Bonds, Notes, and Medium Term Notes (publicly traded & privately placed)
- Mortgage Backed Securities (publicly traded & privately placed)
- Whole Loans
- Asset-Backed Securities
- U.S. Dollar Bonds issued by foreign borrowers (Yankees)
- U.S. Dollar Bonds issued outside the U.S. (Eurodollars)

These fixed income securities are managed internally by ~~The management of all these investments are performed by in-house~~ Investment Officers - Fixed Income, under the direction of the ~~STRS~~ Director of Fixed Income and Equity within the asset allocation and strategic objectives established by the California State Teachers' Retirement Board (Board).

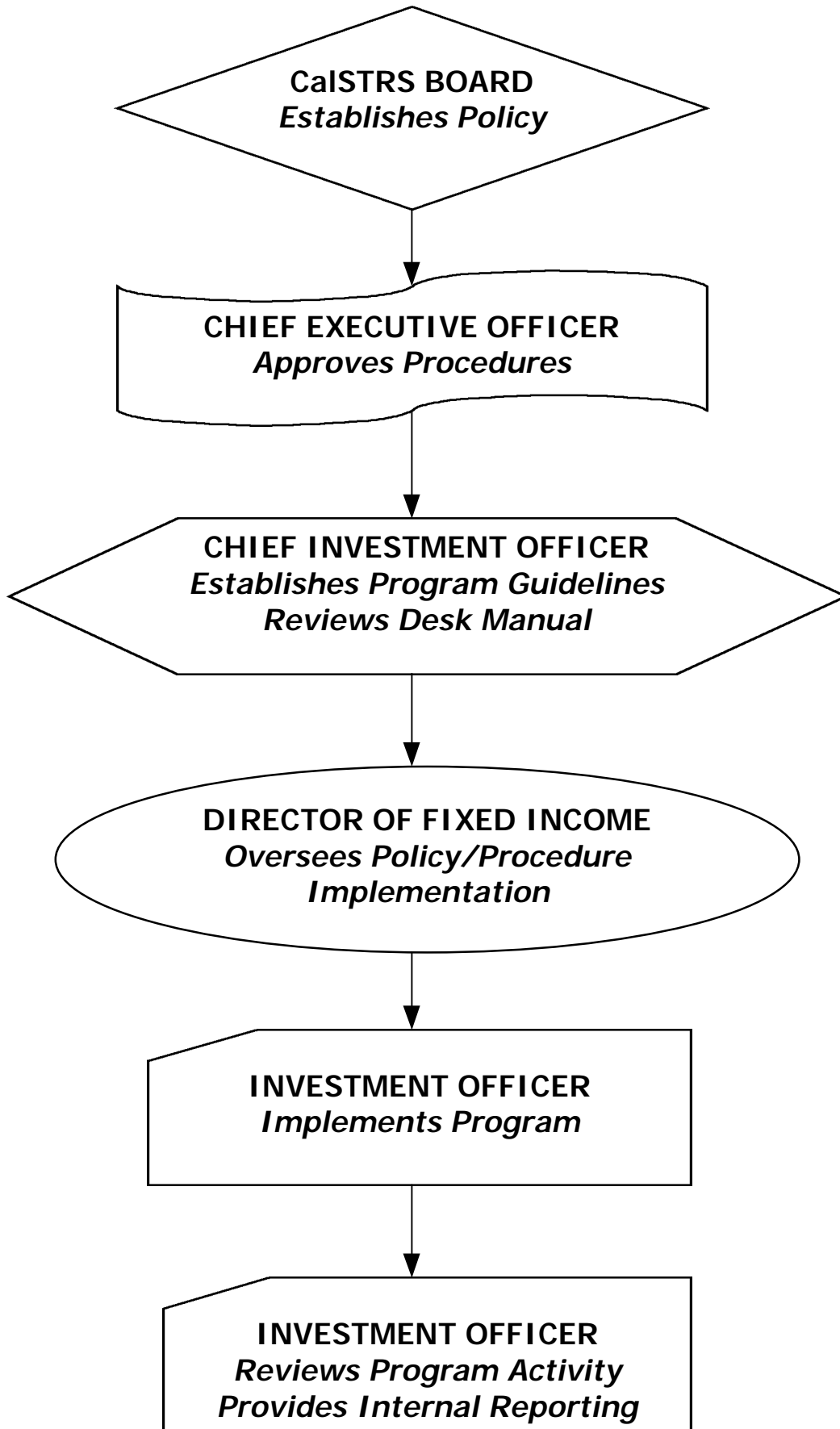
This ~~manual will establish~~ policy document outlines the approved policies and procedures involved in managing Fixed Income investments of CalSTRS' internally managed long-term fixed income portfolios and has been designed to set the boundaries that will ensure prudence and care in the management of the fixed income portfolios while allowing sufficient flexibility in the management process to capture investment opportunities. A flow chart is included to provide the context for the policies within the general process of the management of the internally managed long-term fixed income portfolios. ~~There may be~~ Words and terms that may be are unfamiliar to the reader are so for convenience, these words and/or terms are in bold (on a one time basis) referenced in the Glossary (G-1-3).

The following represent the internally approved policies and procedures used in the management of the fixed income segment of STRS' investment portfolio. The policies are designed to set boundaries for expected performance and structure. These procedures provide a picture of the flow of information within the Fixed Income unit. A flow chart for the general **fixed** income process is included in this section to provide the context for the policies and procedures. The Board of Directors provide the asset allocation and strategic objectives for the fund.

FIXED INCOME PROCESS (GENERAL)



LONG-TERM FIXED INCOME PORTFOLIO FLOWCHART



California State Teachers' Retirement System –INVESTMENT BRANCH
Long-Term Fixed Income Policy Manual

LONG-TERM FIXED-INCOME PORTFOLIO POLICIES

April 1999

The following represent the ~~internally~~ approved policies to be utilized ~~used~~ in the management of the internally managed long-term fixed income segment of the total investment portfolio. ~~The~~ These policies are designed to set boundaries ~~for expected performance and structure~~ that will ensure prudence and care in the management of the fixed income portfolios while allowing sufficient flexibility in the management process to capture investment opportunities. Policies approved by the CalSTRS Board cannot be altered without explicit direction from the CalSTRS Board.

1. **Laws and Statutes** - ~~The fixed income assets of the State Teachers' Retirement System~~ System's internally managed long-term fixed income assets are to be invested in a prudent manner for the sole benefit of its participants and beneficiaries in accordance with the California State Teachers' Retirement Law and other applicable statutes. No investment instrument or activity prohibited by the Investment Resolution adopted by the Board in 1984, as amended from time to time, shall be authorized for the internally managed long-term fixed income portfolios.
2. [Originally Item #4] **Portfolio Objectives** - ~~The performance objective is to achieve a total rate of return which is equal to or slightly better than that of the respective target index. This is to be accomplished through a stratified sampling process (not replication) whereby securities that are anticipated to outperform the index over a 12 to 24 month time horizon are identified. The internally managed long-term fixed income assets shall be invested using an enhanced indexing investment strategy in which the strategic objective is to consistently exceed the total return of the performance benchmark with a similar risk profile. The performance benchmark for the internally managed long-term fixed income assets shall be the Salomon Brothers Large Pension Fund Index (LPF Index). In an effort to achieve optimum performance results in concert with diversifying the fixed income assets each segment of the portfolio will be managed to an Index and/or a specified management criteria. The Index or management criteria will be assigned by the Director of Fixed Income and Equity~~
3. **Diversification** - ~~Diversification by type of issue, quality and maturity will spread the risk in the portfolios. Minimum and maximum ranges shall be established for the fixed income portfolios within the context of the management criteria referenced above. All diversification ranges are subject to change as conditions warrant within investment portfolios is critical in order to control risk and maximize returns. Minimum and maximum ranges with respect to investment sectors, credit exposure, and duration shall be established for the internally managed long-term fixed income portfolios within the context of the characteristics of the performance benchmark. Such ranges shall be documented within the Procedures Manual and are subject to change as conditions warrant, as determined by the Director of Fixed Income.~~
4. [Originally Item #9] **Trade Execution** - Competitive bids/offers are encouraged for all portfolio transactions. However, there are circumstances which ~~dictate non-competitive transactions be completed~~ preclude the competitive process during trading. Such exceptions are to be documented on the trade ticket, and the statistics associated with trading activity included in the monthly fixed

income report. ~~In all transactions the portfolio manager~~ The Investment Officers shall use their best efforts and discretion at all times to obtain the most favorable ~~net results at the time of execution~~ trade execution possible for the System. ~~The number and percent of trades for which competitive bids are received will be reported monthly.~~

5. ~~Positions shall not be undertaken for the sole purpose of aligning average quality. Diversification by credit quality in the fixed income portfolios shall be established by the Director of Fixed Income and Equity. [Included in #3]~~

5. [Originally Item #10] **Authorized Signers** - Authorization letters, which indicate who may ~~open accounts and~~ transact business for the CalSTRS internally managed long-term fixed income portfolios, shall be sent including with a copy of the most recent Investment Resolution, initially at the time ~~the~~ an account is set up opened and then periodically to all fixed income broker/dealers with whom CalSTRS conducts business. Whenever ~~any a~~ a change in ~~Investment Officers~~ authorized signers takes place, ~~these brokerage firms are~~ the broker/dealers shall be notified in writing within 24 hours, in the event of termination, and as soon as possible, in the event of a newly authorized signer(s). (See page 26)

6. ~~Security transactions shall be undertaken as necessary to approximate the characteristics of the target index or management criteria and not solely to reduce short term tracking error. [Included in #2]~~

6. [Originally Item #12] **Authorization Limits** - ~~Graduated limitations of daily trading authority for aggregate indexed transactions are as follows~~ The following daily limits apply with respect to the approval of trade activity within the internally managed long-term fixed income portfolios:

Investment Officer I	\$10 million <u>\$25 million</u>
Investment Officer II	\$50 million <u>\$100 million</u>
Investment Officer III	\$100 million <u>\$250 million</u>
Director of Fixed Income and Equities	\$1 billion <u>\$500 million</u>
Chief Investment Officer	<u>\$1 billion</u>

~~No trading authority limit shall be established on aggregate transactions within the liquidity portfolio.~~

7. ~~No limitation as to **realized losses** will be established. All proposed transactions should be carefully evaluated to determine the net benefit to the Fund and to minimize the impact of realized losses and transaction costs.~~

7. [Originally Item #11] **Trade Processing** - Prior to being processed to Operations, all ~~transaction~~ trade tickets shall be signed by two Investment Officers authorized within the limits noted above and countersigned by two Investment Officers within Fixed Income.

8. ~~No investment instrument or activity prohibited by the Investment Resolution adopted by the Board in 1984, as amended May 11, 1994 (See page 22), will be authorized for the fixed income portfolios. [Included in #1]~~

8. **Business Plan** – The internally managed long-term fixed income portfolios will be managed in accordance with an annual Business Plan. This plan will include a broad overview of the asset class with the key issues associated with the management of the portfolios, as well as future objectives and a resource allocation study.
9. **Delegation of Authority** – The management of CalSTRS' internally managed long-term fixed income portfolios is delegated to staff within the boundaries established by these policies and the processes described within the Procedures Manual.
10. **Reporting** – Staff will prepare a report summarizing the activities associated with the management of the long-term fixed income portfolios on a monthly basis for the Chief Investment Officer. The report shall provide information regarding portfolio performance, risk characteristics vs. the performance benchmark, and trade execution summaries.
11. **Board Review** – The Board shall administer and review this policy periodically, as it deems appropriate in keeping with the investment standard.

**California State Teachers' Retirement System
Long-Term Fixed Income Policy Manual**

GLOSSARY

AGENCY SECURITIES - Investments issued by federal corporations and federally sponsored corporations that are able to issue debt at a lower cost to such constituencies as farmers, homeowners, and students.

ASSET-BACKED SECURITIES - Investments that are collateralized by assets such as automobile loans, agricultural equipment loans, and credit card loans. The loans feature credit enhancements that lead to high credit ratings and limited investor exposure to the credit of the seller.

BANKERS' ACCEPTANCES - Time drafts drawn on and accepted by a bank within one to six months. They are used to provide manufacturers and exporters with capital to operate between the time of manufacturing (or exporting) and payment by purchasers.

BASIS POINT - One hundredth of one percent; .0001 in decimal form.

CASH FORECAST - The projection provided by CalSTRS' Operations division of the sources and uses of cash for the System in the immediate future.

CERTIFICATE OF DEPOSIT (CD) - A negotiable security issued by commercial banks against money deposited with them for a specified period of time. CDs pay interest at either a fixed or floating rate, periodically or at maturity, and the principal when it reaches final stated maturity.

COLLATERAL - Securities and other property pledged by a borrower to secure payment of a loan.

COMMERCIAL PAPER -Unsecured, short term (usually a maximum of nine months) bearer obligations with denominations in multiples of \$100,000.00, issued principally by industrial corporations and finance companies; usually issued at a discount from face value.

COMPETITIVE BIDS - The practice of soliciting more than one bid or offer for a security transaction. It is based on an identifiable asset in accordance with identified fixed rules for all participants.

CORPORATE BOND - A financial obligation for which the issuer, a company, promises to pay the bondholders a specified stream of cash flows, including periodic interest and a principal repayment.

CREDIT RATING - A relative ranking of timely interest payment and principal repayment based on past records of debt repayment, current financial status, and future outlook for the company.

DISCOUNT NOTE (AGENCY) - An obligation of a federal corporation or a federally sponsored corporation issued at a discount to par value, usually less than one year to maturity.

DURATION - The weighted average maturity of the present value of a bond's cash flow stream. A measure of the change in price for a small movement in interest rates.

EURO-DOLLAR DEPOSITS - Certificates of deposit issued by banks outside of the United States, with interest and principal paid in dollars.

FAILED TRADE - Purchased or sold investment securities that are not delivered on the contracted settlement date.

INDEX - A defined representative collection of securities used to measure the change in value of the securities market on a monthly basis.

INDEXED PORTFOLIO - Contains a core portfolio of United States Treasury issues, mortgage-backed securities, and corporate securities.

INVESTMENT OFFICER - Any one of the CalSTRS in-house investment professionals in the CalSTRS Fixed Income unit.

LIQUIDITY - The ease with which a bond can be purchased or sold at a fair price in a timely manner.

LIQUIDITY PORTFOLIO - For CalSTRS' purposes, this is the short-term fixed income portfolio that provides cash flow for funding transactions for the System, such as benefit payments, investment manager activity, and asset allocation. Examples of short-term investments include U.S. Treasury, Agency, and money market securities (commercial paper, certificates of deposit, Euro-dollar deposits, repurchase agreements).

MEDIUM TERM NOTE - Medium Term Notes (MTNs) are corporate or agency debentures. They differ from traditional underwritten corporate bonds only in the process by which they are issued. MTNs typically are offered on a periodic or continuous basis through one or more managers acting as agents.

MORTGAGED-BACKED SECURITY (MBS) - A security that is issued by a federal agency, such as the Federal Home Loan Mortgage Corporation, the Federal National Mortgage Association, or the Government National Mortgage Association that is backed by mortgages. Payments to investors are received out of the interest and principal of the underlying mortgages.

MOTIVATION - The force, intent, or impulse that causes the Investment Officer to approach a transaction or series of transactions in a particular way.

PAR VALUE - The underlying stated value of a bond. The par value serves as the basis for calculating coupon payments and settlement details.

PORTFOLIO - A collection of stocks, bonds or money market securities owned by an investor and segmented by a predefined method.

POSITION - The status of securities, futures, and options in an account - long or short.

PRINCIPAL PAYDOWN - The portion of a periodic payment that reduces the amount of the principal.

PRIVATE PLACEMENT - The purchase of a security directly from the issuing corporation.

QUALITY RANGES - Guidelines for the percentage of market value of a particular credit rating within a portfolio.

RATE OF RETURN - The total income received over a period of time, including interest income, accretion of discount, amortization of premium and change of market value; usually expressed as a percentage or in decimal format.

REALIZED LOSS - The excess of a bond's book value on the date of sale over the sale's proceeds.

REPURCHASE AGREEMENT (REPO) - An arrangement or contract with a dealer to purchase a government, agency or other security at a fixed price, with provisions for its resale at the same price at a rate of interest determined competitively.

SETTLEMENT DATE - For each security transaction, a price is established based on the specifics of the security and the payment date. The payment date, or when the security is exchanged for value, is called the settlement date.

SHELF REGISTRATION - The maximum amount of a medium term note issue.

SINKING FUND - The periodic retirement of a portion of a principal amount of a bond issue. A pre-specified schedule determines the timing and the amount of the sinking fund payments.

SPLIT-RATED - The credit ratings of corporate and other securities are made by independent services such as Moody's or Standard & Poors. When a security receives ratings that are different among the rating services, the term split-rated is used to signify this difference in relative credit ratings.

TRACKING ERROR - The deviation of the portfolio's rate of return from that of the target index or management criteria.

UNITED STATES TREASURY SECURITIES - Debt issues of the U.S. Government, such as Treasury bills, notes and bonds.

WHOLE LOANS - A secondary mortgage market term which refers to an investment in an original mortgage loan, versus a loan which participates in a secured pass-through security.

PROPOSED
RESOLUTION TO THE
CALIFORNIA STATE TEACHERS' RETIREMENT BOARD
INVESTMENT COMMITTEE

SUBJECT: Long-Term Fixed Income Policies

Resolution No. _____

WHEREAS, the Investment Committee of the California State Teachers' Retirement Board is responsible for recommending to the Board, investment policy and overall investment strategy; and

WHEREAS, the Investment Committee has received and reviewed the Long-Term Fixed Income Policies and has heard oral presentations from Staff; and

WHEREAS, the Staff has recommended the adoption of the Long-Term Fixed Income Policies; Therefore be it

RESOLVED, that the Investment Committee of the California State Teachers' Retirement Board adopts the Long-Term Fixed Income Policies.

Adopted by:
Investment Committee
on _____

James D. Mosman
Chief Executive Officer